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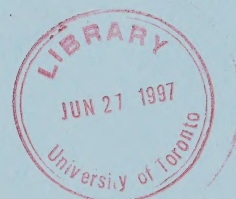


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**FINANCIAL MARKETS AND GOVERNMENT
POLICIES: A FAVOURABLE VIEW**

Richard Domingue
Economics Division

August 1996



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TABLE OF CONTENTS

	PAGE
INTRODUCTION.....	1
THE GLOBALIZATION OF CAPITAL: A FEW STATISTICS.....	3
THE TRADITIONAL POWERS OF GOVERNMENT: A VANISHING SPECIES	11
THE POSITIVE IMPACT OF THE GLOBALIZATION OF FINANCIAL MARKETS ON MONETARY POLICY	15
THE POSITIVE IMPACT OF THE GLOBALIZATION OF FINANCIAL MARKETS ON TAX POLICY	16
CONCLUSION	19
SELECTED BIBLIOGRAPHY	21



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FINANCIAL MARKETS AND GOVERNMENT POLICIES: A FAVOURABLE VIEW

INTRODUCTION

Shortly after the end of Soviet hegemony over the countries of the East Bloc, the following graffiti were seen in Poland: "We wanted freedom. Instead, we got the obligatory market." Some critics around the world feel that the forces of capital and the financial markets have become too powerful. They think that governments no longer exercise any control over tax and monetary policies because the policies in question are now dictated by the forces of the financial market. These critics denounce what they see as the "privatization" of monetary and tax policies which are now, they claim, determined by brokers, exchange dealers and major portfolio managers.

Those opposed to the forces of the financial market say that, instead of striving to meet the real needs of the public (by creating jobs or maintaining the social safety net, for example), governments are obsessed by the strict demands of the financial markets. The opponents of the market forces feel that governments should be free to govern. They accordingly argue that if governments ended speculative trading and imposed better controls on movements of capital, they would regain their full sovereign powers, since they could then use all the means normally available to a sovereign state to manage its economy.

It is true that major economic upheavals have occurred in the financial markets. First, governments throughout the world have such high levels of debt that they siphon off a large part of the capital available in the world; the growing deficits in the current account balances of a number of countries, including the industrialized countries, provide a clear illustration of this phenomenon. Second, business is becoming more global. To meet their

needs for capital, companies can access the same large pools of capital as governments. Third, the loosening of restrictions on financial institutions and the recent proliferation in certain financial instruments (derivatives, for example) mean that capital has never had such freedom to move around the globe. Finally, the market for information has become a single large and powerful global market.

The globalization of the financial markets and the speed with which information moves mean that the slightest economic and political shock can have a major impact on the economic welfare of a large part of the world. In global terms, investors are informed almost instantaneously of any change that may affect the return on their investments. The volume of transactions concluded daily around the world is such that an incorrect risk assessment may lead to losses of several hundred million dollars in only a few seconds. It should not come as a surprise therefore that under these conditions investors and exchange dealers are highly averse to risks or any uncertainty.

It is also true that the forces of the financial markets are highly intolerant. They either like you or they don't. If they approve, they will reward the governments that they feel are making the right decisions. However, if they find the policies of a government unacceptable, they will punish it severely and quickly by giving its bonds, currency and interest rates a rough ride. There can be no doubt that it is better to have these market forces with you than against you.

It can, however, be argued that the globalization of this market has major benefits for government. Financial forces can act as alarm systems and force governments to make the necessary decisions; they can be reliable allies in the search for sound government finances and price stability. Without them, many governments, motivated solely by prospects of electoral advantage, might be tempted to apply policies that could have disastrous consequences. This paper presents the argument in favour of globalization of financial markets.

THE GLOBALIZATION OF CAPITAL: A FEW STATISTICS

There are several ways to measure the extent of capital integration. One is to measure the gap between real interest rates in various places around the globe. It would be normal for an integrated financial market to dictate a world price for this capital. Given the many risk factors that can influence the cost of capital (a government defaults on its payments, political stability, public debt, risk of currency devaluation, inflation forecasts), real interest rates for a given term should be similar. In a recent article, Norman Fieleke of the Federal Reserve Bank of Boston noted that the three-month securities of several countries bore almost identical real interests rates.⁽¹⁾

However, the difference in real long-term interest rates is a better indicator of how unified the financial markets are.⁽²⁾ In his article, Fieleke shows that, from 1980 to 1994, rates on long-term bonds in 19 countries were almost exactly the same. Consequently, because the financial markets are integrated, risk-adjusted real interest rates are similar in the major industrialized countries.

On the other hand, not everybody shares this conclusion. Some indicators suggest that markets are not as fully integrated as Fieleke suggests. There is, in fact, a close correlation between the savings rate and the level of investment. Thus, economies with low savings rates generally also have a low level of investment. The converse is also true. However, if capital were fully mobile, domestic savings would end up in the hands of investors offering the best opportunities, often in foreign countries. In reality, only 10% of the 500 largest portfolios in the world is invested in foreign stocks.⁽³⁾

(1) Norman S. Fieleke, "International Capital Movements: How Shocking Are They?" *New England Economic Review*, Federal Reserve Bank of Boston, March-April 1996, p. 42-43.

(2) It is possible to speak of *ex-post* real interest rates (the nominal rate paid to investors minus the observed inflation rate) or *ex-ante* (the nominal interest rate minus the forecast inflation rate, which is based on historical trends and the target spreads used by central banks). Investment and savings decisions are based on expectations. Accordingly, the real *ex-ante* interest rates must be used in comparing rates of return.

(3) "Who's in the Driving Seat," *The Economist*, *Survey of the World Economy*, 7-13 October 1995, p. 6.

In effect, regardless of who is right and whether or not the financial markets make up a perfectly unified single global market that dictates a world price for capital, it is certain that several billion dollars can be moved from one part of the globe to another in a matter of minutes.

The daily value of transactions in the foreign exchange markets increased from US \$640 billion in 1989 to a trillion dollars (\$1,000 billion) in 1992.⁽⁴⁾ Four years later, everything suggests that the amounts changing hands daily on the world capital market are even higher. In fact, the latest figures suggest that the figure is now US\$1.3 trillion.⁽⁵⁾

Because of all the financial and technological upheavals that have occurred, real annual average growth in transactions in foreign currency, bonds and stocks by far exceeds real average annual growth in economies and the value of goods and services exported around the world. Between 1980 and 1982 average annual growth in currency transactions exceeded the growth in economies and the value of goods and services exported by 25% while growth in bond transactions was 10% higher.⁽⁶⁾ During the same period the value of stock exchange transactions grew two and a half times faster than the size of economies.

As Table 1 and Chart 1 show, the proliferation in derivative instruments is an important indicator of the globalization of capital. The nominal value of transactions involving negotiable securities traded over the counter alone was eight times greater in 1991 than in 1986. The value of exchange-traded derivatives in the stock markets increased 600% over the same period.⁽⁷⁾ In 1991, the total value of transactions was close to \$8,000 billion and by 1994 the value of transactions had already exceeded \$20,000 billion.⁽⁸⁾ In terms of

(4) In 1992, exchange dealers handled US \$880 billion in currency and \$200 billion in bonds every day ("Who's in the Driving Seat?" (1995), p. 4). See also John Calverley, "The Currency Wars," *Harvard Business Review*, March-April 1995, p. 146.

(5) "Who's in the Driving Seat?," (1995), p. 10.

(6) *Ibid.*, p. 4.

(7) Bank for International Settlements, *Recent Developments in International Interbank Relations*, Basel, June 1990, Table 6, p. 49.

(8) "Who's in the Driving Seat?" (1995), p. 9.

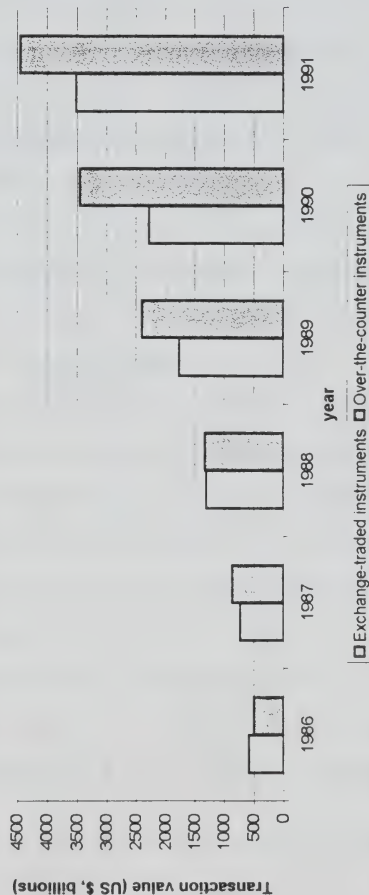
Table 1: Market for selected derivative instruments

Notional principal amounts outstanding at end-year, in billions of US dollars equivalent

	1986	1987	1988	1989	1990	1991
Exchange-traded instruments						
of which: Interest rate futures	583	725	1 300	1 762	2 284	3 518
Interest rate options	370	488	895	1 201	1 454	2 159
	146	122	279	387	600	1 072
Over-the-counter instruments						
of which: Interest rate swaps	500	870	1 330	2 402	3 451	4 449
	400	683	1 010	1 503	2 312	3 065
Total	1 083	1 595	2 630	4 164	5 735	7 967

Ref. Bank for International Settlements, *Recent Development in International Interbank Relations*, Basle, October 1992, table 6, p. 49.

Traded Value of Selected Derivative Instruments



annual volume (Table 2), the market for futures on short-term interest rate instruments grew by 517% from 16.4 billion transactions annually in 1986 to 84.8 billion in 1991.⁽⁹⁾ It is not surprising, therefore, that such a large and integrated global derivatives market exerts great influence on economies.

The explanation for these huge capital movements is the extraordinary demand for capital. In many countries these needs are greater than available domestic savings. Because they are unable to obtain funds in domestic markets, a number of countries are now forced to import capital. The stock of government bonds in circulation on international markets, as a percentage of international financial securities, increased from 18% in 1980 to 25% in 1992.⁽¹⁰⁾ Canada's financial needs are no exception to this rule.

Chart 2 shows the sources and uses of savings in Canada in 1995. Public and private needs for capital in that year were \$158 billion. Because domestic savings amounted to only \$143 billion, Canada had to import \$13 billion in foreign capital.⁽¹¹⁾ One year earlier Canada had had to import \$22 billion from abroad.

In 1996, Canada recorded a surplus and could accordingly start to repay its foreign debt. It will no longer have to borrow abroad to meet its needs for capital. What characterizes Canada's public and private debt is the share of the debt as a proportion of GDP that is held by foreigners; this exceeded 40% of the total debt of \$340 billion in 1994. The federal share of this (including Crown corporations) was \$135 billion, the provinces' share was \$155.2 billion and the municipal sector's share \$6.6 billion.

As can be seen in the bar chart reproduced below (Chart 3), in 1994-1995 over 25% of the federal government's total debt was held by foreign portfolio managers. Ten years earlier this figure was only 11%. This increase can be explained by the fact that, as the budget position of governments in Canada deteriorated during the 1980s and early 1990s, and

(9) *Recent Developments in International Interbank Relations* (1990), Table 12, p. 55.

(10) "Who's in the Driving Seat?" (1995), p. 10.

(11) The current situation has improved considerably over 1994. The reduction noted in 1995 may be explained by the reduction in the public sector deficit and by an increase in the level of domestic savings. On the other hand, in 1994, Canada's trade balance had improved a great deal since the previous year. (In 1993, the trade balance was \$9.3 billion in Canada's favour, while in 1994 it was \$15 billion and in 1995 \$28.2 billion.)

Table 2 - Annual turnover in derivative financial exchange-traded instruments

Growth 1991/1986
Percentage

	1986	1987	1988	1989	1990	1991
Futures on short-term interest rate instruments	16.4	29.4	33.7	70.2	75.8	84.8
Futures on long-term interest rate instruments	74.6	116.3	122.6	130.8	143.3	149.7
Currency futures	19.7	20.8	22.1	27.7	29.1	29.2
Interest rate options	22.2	29.3	30.5	39.5	52.0	50.8
Currency options	13.0	18.2	18.2	20.7	18.8	21.5
Total	145.9	214.0	227.1	288.6	319.1	336.0
<i>of which: in the United States</i>	<i>122.9</i>	<i>161.4</i>	<i>165.3</i>	<i>198.1</i>	<i>205.7</i>	<i>199.7</i>
<i>in Europe</i>	<i>9.8</i>	<i>27.2</i>	<i>32.6</i>	<i>49.0</i>	<i>61.0</i>	<i>84.2</i>
<i>in Japan</i>	<i>9.4</i>	<i>18.3</i>	<i>18.8</i>	<i>23.7</i>	<i>33.6</i>	<i>30.0</i>

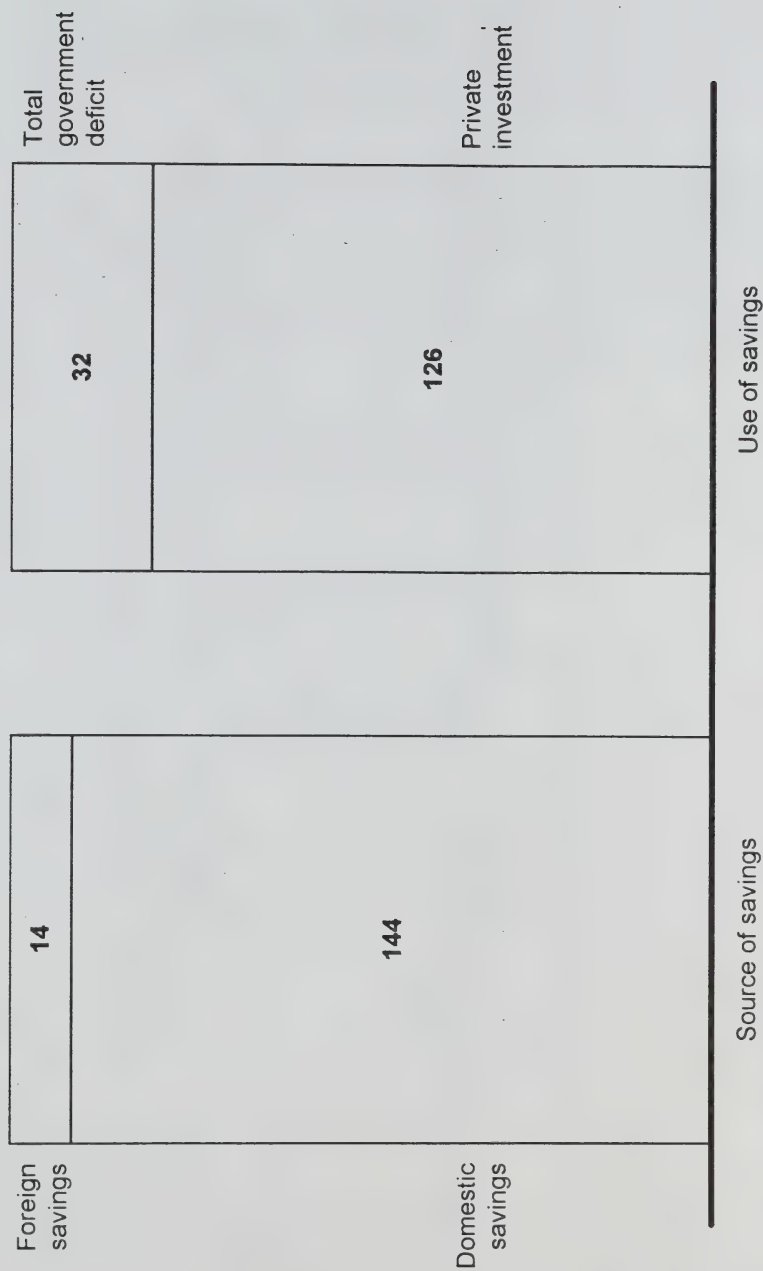
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Ref. Bank for International Settlements, Recent Development in International Interbank Relations, Basle, October 1992, table 12, p. 55.

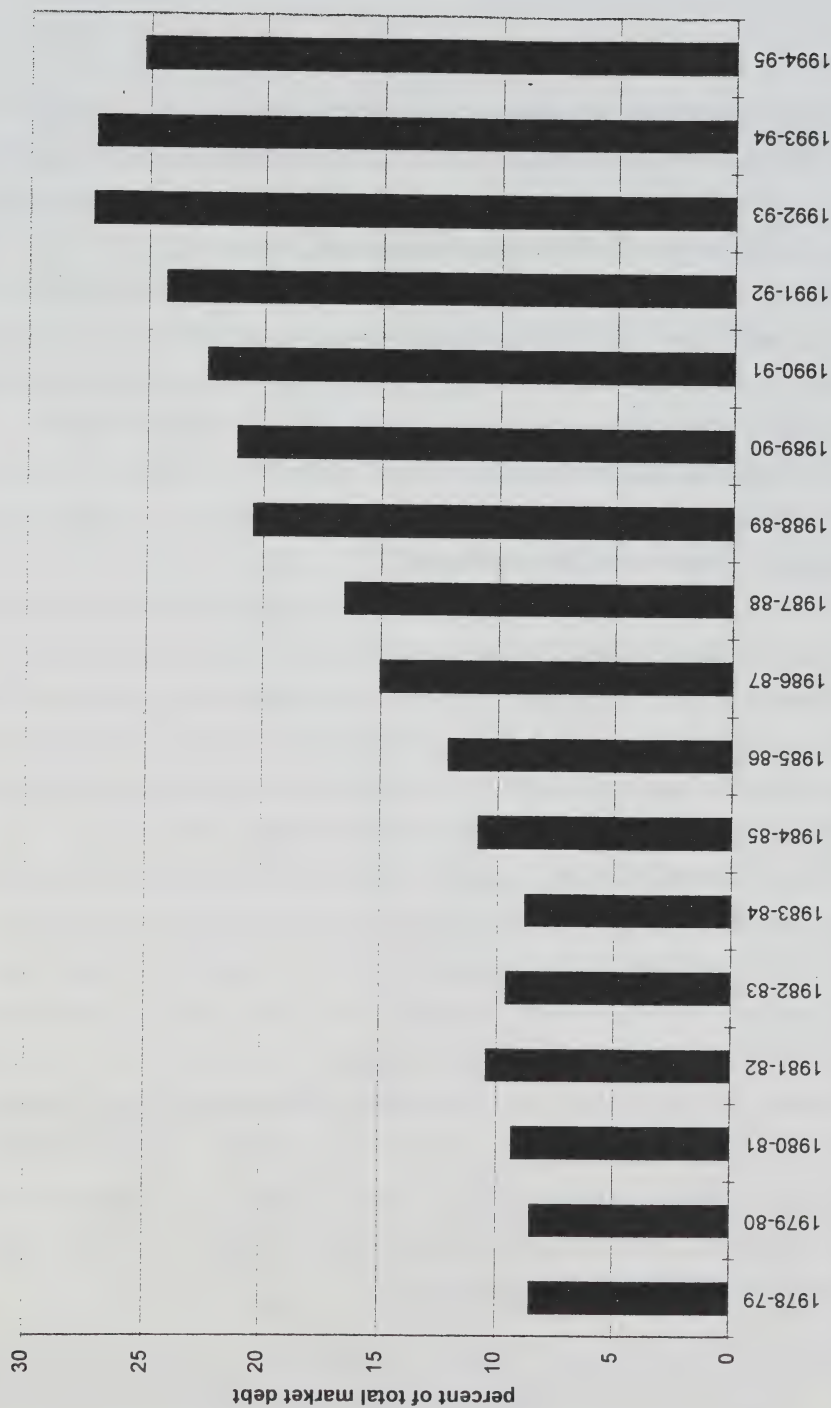
Chart 2 - Sources and Uses of Savings, 1995

(billions of dollars)



Note : Government deficit is on a National Accounts basis.
Source : Statistics Canada.

Chart 3 - Non-resident holdings of Government of Canada debt



Source : Debt Operations Report, Department of Finance, December 1995.

as private corporations experienced a greater need for capital, the government of Canada had to import capital from abroad on an increasing scale. Because the needs of government made such major demands and as the budget situation of these governments deteriorated, corporations also had to borrow increasingly abroad.

Canada is not the only country that has had to import capital from abroad. Several industrialized countries have also had to tap the markets. A country's net capital flow (that is the difference between funds arriving from abroad and those moved abroad) is equal to the balance of payments in the current account. The current account balance includes the merchandise trade balance (that is the difference between goods exported and goods imported) and the non-merchandise trade balance⁽¹²⁾ (that is the net balance in services supplied outside Canada and arrivals and departures of capital).

A country that imports more than it exports must borrow on foreign markets in order to fund this difference. This net import of capital is equal to the current account deficit. Conversely, a country that exported capital would show a surplus in its current account. Despite the fact that Canada has a positive balance in merchandise trade, it had until recently a negative current account balance. This situation can be explained by the fact that the funds generated by exports of goods were not sufficient to finance all of Canada's needs. In fact, the balance in non-merchandise trade was much lower than that in merchandise trade. In effect, Canada's balance in non-merchandise trade shows that, since the mid-1980s, between \$24 and \$41.4 billion have gone abroad. In 1995, the merchandise trade balance exceeded \$28.2 billion. In the same year, when Canada was paying interest, it received only slightly over \$16 billion from dividends and profits abroad that amounted to over \$49 billion. At the same time Canadian tourists spent \$16.5 billion abroad while foreign tourists spent only \$11.7 in this country. Canada also imported more services from abroad than it exported. Given these figures, it is not surprising that there is a deficit in non-merchandise trade so great that it completely neutralizes any surplus in the merchandise trade balance; this explains the repeated deficits in the current account balance.

(12) The invisible trade balance includes the following items: the balance of services (including the tourism balance), the balance of investment income (including dividends and profits), and the balance of transfers (including estates and capital moving from and to foreign countries).

During the second quarter of 1996 (April to June), Canada's current account balance showed a surplus of \$1.15 billion. The merchandise trade surplus exceeded \$9.96 billion while the balance in non-merchandise trade showed a deficit of \$8.82 billion. On an annualized basis, Canada's current account surplus is \$4.58 billion (merchandise trade balance: \$39.84 billion; balance in non-merchandise trade: -\$35.26 billion). Among the explanations for this surplus are the recent declines in interest rates and improvements in public finances. Governments in Canada are now borrowing less abroad.

This is the first time since 1984 that Canada has enjoyed such surpluses. Only three years ago, of the member countries of the G-7, Canada was the one showing the largest current account deficit as a proportion of GDP. The Scotia Bank now forecasts that in 1997 Canada will be one of the four capital-exporting countries. Italy, Japan and France will also record positive current account balances.

This good news will improve the value of the Canadian dollar on the exchange markets. Furthermore, if the surplus continues, the Bank of Canada will be able to maintain interest rates with more of a downward trend than those in the United States. Finally, Canadians can start paying back the hundreds of billions of dollars they owe to foreigners.

Table 3 illustrates the globalization of the financial markets by showing current account balances as a percentage of GNP or of GDP in the member countries of the G-7 and a few other selected countries from 1980 to 1994. These balances clearly show the financial needs of a number of countries and the importance of foreign capital in financing their domestic needs.

THE TRADITIONAL POWERS OF GOVERNMENT: A VANISHING SPECIES

In addition to foreign affairs and national security, all modern governments wish to have complete sovereignty to conduct and influence their social and economic policy. On behalf of the citizens they represent, these governments want to have every freedom to decide on and choose policies on taxation, income redistribution, public spending, the size of the debt and the deficit, interest rates, exchange rates and capital movements.

Table 3 - Current-account Balance as a Percent of GNP/GDP, Selected countries, 1980 to 1984
Positive sign implies capital outflow, negative sign an inflow

	Canada	France	Germany	Italy	Japan	United Kingdom	United States	Australia	Portugal	Switzerland	Sweden
1980	0.59	-0.63	-1.73	-2.29	-1.02	1.27	0.08	-2.79	-4.35	-0.19	-3.53
1981	-2.00	-0.82	-0.50	-2.53	0.41	2.74	0.16	-4.88	-20.03	3.47	-2.48
1982	0.54	2.19	0.76	-1.77	0.63	1.63	-0.36	-4.86	-14.82	2.51	-3.34
1983	0.45	0.99	0.83	0.21	1.75	1.14	-1.30	-3.69	-8.28	1.19	-0.87
1984	-0.21	-0.18	1.54	0.71	2.76	0.42	-2.62	-4.80	-3.46	6.38	0.59
1985	-1.34	-0.01	2.73	0.91	3.65	0.72	-3.09	-5.54	1.95	6.15	-1.22
1986	-2.87	0.33	4.50	0.40	4.31	-0.23	-3.53	-5.68	4.09	3.28	-0.11
1987	-2.92	-0.50	4.15	-0.32	3.59	-1.19	-3.68	-3.84	1.22	3.52	-0.10
1988	-3.59	-0.50	4.23	-0.79	2.73	-3.49	-2.61	-4.23	-2.61	4.57	-0.42
1989	-4.28	-0.59	4.82	-1.37	1.97	-4.34	-1.96	-6.41	0.34	4.31	-1.78
1990	-3.89	-1.29	3.05	-1.54	1.21	-3.37	-1.66	-5.29	-0.30	2.94	-2.91
1991	-4.21	-0.59	-1.18	-2.09	2.16	-1.44	-0.12	-3.47	-1.04	4.29	-1.96
1992	-4.00	0.33	-1.17	-2.28	3.19	-1.69	-1.13	-3.79	-0.22	5.67	-3.55
1993	-4.47	0.82	-0.86	1.12	3.11	-1.87	-1.64	-3.81		6.88	-2.19
1994	-3.43	0.31	-1.27	1.53	2.79	0.00	-2.31				0.43
Average in absolute value	2.77	0.72	2.38	1.42	2.52	1.82	1.88	4.85	5.23	4.26	1.82

Ref Norman Fielege, "International Capital Movements: How Shocking Are They?" *New England Economic Review* Federal Reserve Bank of Boston, March-April 1996, p 44-45

Governments derive economic power from their ability to tax and regulate the financial markets and their ability to issue bank notes and to borrow. Barely 25 years ago, governments had much greater freedom to govern than they have now, and they could choose the economic policies they considered appropriate. However, the world of finance has changed a great deal in a very short time and the situation has changed entirely. According to the opponents of the free market, it is precisely this market that limits the powers and influence of government. One of them, Gregory Millman, describes the situation as follows:

Like the vandals who conquered decadent Rome, the currency traders sweep away economic empires that have lost their power to resist. Time after time in country after country, when governments can't cope with the new financial realities, traders are the agents of creative destruction. Although investors have always had to take into consideration the quality of a government's management of its economy, traders now have an unprecedented degree of power to sweep the financial foundations out from under poorly managed, politically unstable, or uneconomic governments before the bureaucracy even know what has happened.⁽¹³⁾

This view is shared by a number of opponents of the financial markets.

It is true that governments' discretionary powers and their influence on policy have now been considerably reduced. First of all, the power to tax is severely restricted when companies or individuals can easily move their capital abroad. Second, the power to regulate the financial markets does not mean much when typically millions of billions of electronic transactions are concluded on them. Finally, the power to print money and to borrow in order to finance a budget deficit to some extent no longer exists since market forces can neutralize any monetary or tax policy that they consider unwise.

While agents do not like to see a country's monetary policy relaxed (for example, because they feel it is inflationary), they will influence long-term interest rates by divesting themselves of government bonds. Demand for these instruments will decline and this will be reflected in a drop in the price of long-term bonds and consequently in an increase

(13) Gregory J. Millman, *The Vandals' Crown: How Rebel Currency Traders Overthrew the World's Central Banks*, The Free Press, New York, 1995, p. xii.

in interest rates. In this way brokers can neutralize any action of a central bank that was aimed, for example, at reducing interest rates if they feel that such an approach is unwise.

Brokers seek the highest returns for their money. Regardless of where they are on the globe, brokers who disapprove of a government's budget policy (for example, because they feel it will worsen the deficit and ultimately lower their returns) will force its currency and bonds into free fall simply through a few electronic transactions. Thus, the slightest increase in Canada's or a province's deficit or even the slightest increase in the tax burden would pose major risks. The bonds held by foreigners probably have a greater turnover rate than bonds held by Canadians. Consequently, the slightest variation in risk leads to rapid adjustments. The financial markets would therefore react vigorously to any decline in Canada's budget position.

However, the market will reward any move towards an increase in real returns caused by a reduction in the deficit or any monetary policy that encourages the tendency to save since these policies will reduce inflationary tensions and improve the current account balance. Thus, the spread between Canadian and American interest rates has grown much smaller. In fact, we have never before seen such a small differential in bond prices. The financial markets ended by recognizing the serious efforts being made by governments in Canada to reform their budgets. As a result, investors are now prepared to accept a lower return on their Canadian investments because of the reduced risk.

The fiscal and monetary levers used in the past are no longer under the control of governments and opponents of the global financial market forces would like to win back this control. It is true that with the globalization of financial markets, financial innovations and the information revolution, market forces of the financial market will in future hold the balance of power between governments. There are, however, benefits resulting from this great financial market, such as access to greater pools of capital for business expansion. Governments can reap the benefits that market forces have on monetary and tax policies.

THE POSITIVE IMPACT OF THE GLOBALIZATION OF FINANCIAL MARKETS ON MONETARY POLICY

Every year, during the federal government's pre-budget consultations, a number of participants suggest that the Bank of Canada should relax its monetary policy. They claim that the Bank would merely have to reduce interest rates unilaterally for the country's budget problems to be solved, the economy to grow and jobs to be created. In their view, interest rates are far too high and suffocate any chance of growth. On the other hand, they argue that excessively high interest rates increase the cost of servicing the public debt; they feel that, by reducing these rates, the government could reduce debt-servicing costs and stimulate overall demand and economic growth. In order to reduce interest rates, the Bank of Canada would, in their view, only have to print money so that the dollar would be less rare.

Moreover, if the Bank reduced interest rates when this was not called for, it would risk overheating the economy. Because financial markets would be gripped by nervousness, the artificially created economic growth would not last very long. In an attempt to protect themselves against the risk of a recurrence of inflation, the holders of Canadian securities would dispose of them, thus exerting upward pressure on long-term interest rates and downward pressure on the value of the Canadian dollar and neutralizing any attempt to loosen monetary policy. In effect, then, a reduction in interest rates would neither reduce unemployment nor boost the Canadian economy. Action of this kind by the Bank would jeopardize the low inflation rate and have serious economic consequences. Markets do not forgive unfounded actions. If governments wish to influence job creation and stimulate economic growth, they can concentrate on price stability, tax policy and sound public finances. In the medium term such stability will create an environment conducive to job creation, growth and investment.

With the globalization of financial markets and flexible exchange rates, governments can reduce interest rates, if the situation calls for such action, without suffering harmful consequences. Thus, in 1995, the Bank of Canada relaxed its monetary policy when authorities found that it had been too restrictive. When the central bank reduced interest rates, the essential prerequisites for price stability were already in place. There was surplus

production capacity, which had been underestimated. Because the Canadian economy had grown less than expected, there was an increase in unused resources in the labour market and in surplus production capacity. The financial markets were convinced that the Bank of Canada was acting cautiously and that this downward adjustment in the base rate would not threaten the fundamental objective of promoting a rate of growth in the money supply that would not force inflation rates beyond the 1 to 3% range until late 1988. If they had not believed that the reduction was justified, the markets would never have tolerated such a risky move. The economic situation, expectations and the perception of the markets determine how much room the central bank has to manoeuvre.

It is important to note that the Bank of Canada can have a direct influence on very short-term rates (such as one-day rates). Beyond that, its influence is very indirect. For example, in the case of long-term rates (such as rates on ten-year bonds), the central bank acts through inflationary expectations. It can influence these expectations by showing the financial markets that inflation is in check. If the markets feel that there is a risk of inflation, they will force increases in long-term interest rates through their activities in the bond markets. To some extent, markets act as automatic stabilizers since this sudden increase in long-term rates limits the economy much more quickly than the gradual increase in short-term rates that would have been imposed by a central bank. Unavoidable market forces neutralize any monetary policy that is felt to be unwise.

The central banks must choose policies that guarantee price stability (a policy that will be rewarded by the financial markets). They do not have the luxury of opting for expansionary monetary policy that would damage inflationary expectations (a risky policy that would be roundly condemned). Market forces must accordingly be viewed as partners guiding the central banks when they flirt with price instability.

THE POSITIVE IMPACT OF THE GLOBALIZATION OF FINANCIAL MARKETS ON TAX POLICY

The globalization of the market for capital also allows governments to fund their debt and their current account deficits much more cheaply than they could formerly.

Thanks to this major pool of international capital, even governments with serious budget problems can easily borrow at lower cost because good governments to some extent subsidize the cost of capital. The slightest differential in the interest rates offered to investors will attract foreign capital. The paradox is that this free access to international capital can also harm economies because governments can grow increasingly big. Because of their easy access to capital, countries like the United States became net borrowers in the early 1980s.⁽¹⁴⁾

However, there can be no doubt that in the final analysis the globalization of the markets limits the possibility of government intervention. As the budget situation grows worse, the ability to borrow is reduced. The time comes when the markets no longer tolerate a budget situation that they consider to be dangerous. When this happens, governments must often cut spending and reduce government activity by redefining the role of government and privatizing a host of public activities, for example.

A country's budgetary health influences movements of capital. Because foreign investors have major portfolios, it should not come as a surprise that they are vulnerable when the budget situation of a government goes from bad to worse. In a situation such as that in Canada, where until very recently the public debt was growing more quickly than the ability to repay it, any increase in the deficit increased government financial needs by billions of dollars. Even a slight deterioration in the financial situation of a heavily indebted government could mean a major decline in bond prices, which would lead to a significant increase in interest rates and *de facto* an increase in the cost of servicing the public debt. Canada is not immune to this risk.

As governments borrow capital, the markets grow concerned because a government's ability to pay and repay is correspondingly reduced. Coping with these major financial obligations becomes difficult and the time comes when the markets are not going to tolerate it any more. A crisis of confidence follows. As David Dodge said in 1993:

(14) With a fixed exchange rate system, such as existed between 1944 and 1972 under the Bretton Woods Agreement, where international capital movements were limited, governments had to finance current account deficits from the capital available on the domestically and their reserves. Large budget and trade deficits were to some extent impossible.

You sort of come up against and hit a wall and, bingo, you're in terrible troubles. ... You go a long, long way, and then the cliff is very steep. We're working at night here and you never quite know exactly where the edge of the cliff is. All I can say is that we're near enough to the edge that you can smell the sea out there somewhere, so we would be ill advised to get any nearer to the edge of the cliff.⁽¹⁵⁾

New Zealand, Italy, Mexico and Sweden have already found themselves in this situation.

The number of options available to a government in this tight corner is extremely limited. Since it is so deeply in debt, it could attempt to solve the problem by raising taxes on individuals and companies. However, because of the globalization of the financial markets, it cannot impose tax increases that are disproportionate to the rates in other countries. In fact, because capital is very mobile, a business can move some of its operations to other countries where the corporate tax burden is relatively less onerous.

Markets also become concerned when an indebted government could, out of desperation, choose policies that run the risk of fuelling inflation. Rather than cutting spending in order to solve its budget problems, a government that is short of ideas might be tempted to stimulate its economy, increase public spending, cut interest rates, monetize the debt, impose restrictions on movements of capital or force banks to hold a big percentage of government bonds. Because of their fear that such policies would cause even further damage to already precarious government finances, the markets would simply dispose of their bonds.

From the point of view of government policy, this fear felt by the markets in response to budget problems means that a government can lose a number of the counter-cyclical economic levers used, for example, in a recession. Thus, because they are afraid that the unease about the budget will subside, the financial markets will no longer allow a government that does not have the ability to pay for its spending to increase public expenditures even to improve the social security net in a very severe economic slow-down.

It is a paradox that the solution to a country's economic problems often lies in spending cuts rather than in stimulating the economy. For a number of heavily indebted

(15) Standing Committee on Finance, *Record of Proceedings and Testimony*, 1 June 1993, p. 65:35.

countries, cuts in public spending might stimulate the economy because they would have the effect of reducing interest rates and debt-servicing costs. This reduction in interest rates would lead to the stimulating effect.

Canada provides a good illustration of this paradox. The position of the current account balance has been improving steadily since 1993 and interest rates have fallen or held steady. The people of Canada are beginning to enjoy the benefits of sound management of government finances, hard though this may be to swallow. It is wrong to see the restraints imposed by the world of international finance as bad in themselves but rather as providing protection against harmful tax policies.

CONCLUSION

As Gregory Millman states:

Like bounty hunters in the Old West, the traders endorse the economic law not for love of law, but for profit. They have only one goal -- making money. [Traders] are financial vigilantes. Because governments could not provide financial law and order, traders took the law into their own hands. They sell protection at a price.⁽¹⁶⁾

In order to control these forces better, opponents of the free market, such as Millman, say that it is time for governments to control movements of capital and to tax financial transactions. They think that by putting an end to speculative transactions, governments will regain their full sovereignty. On this subject, the Governor of the Bank of Canada stated in his testimony to the Standing Committee on Finance one year ago that:

The Tobin tax, which is to try to discourage currency-related flows, is not going to discourage speculators. It could in fact be harmful for the ordinary transactions. The real problem is that financial transactions frequently get done at very narrow margins. So your ordinary run-of-the-mill financial transaction, ... tends to be done at very narrow margins.

(16) Millman (1995), p. xiii.

Speculative activity frequently is in search of very large gain, so you would have to have a Tobin tax that was incredibly large if you were going to discourage the speculative movements. ... [Y]ou would discourage all legitimate financial transactions.⁽¹⁷⁾

Such a tax would impede the mobility of capital and increase its cost. It is impossible, in fact, to go after speculative transactions alone; consequently, all transactions, whether good or bad, would be affected if a tax were imposed. On the other hand, rather than stabilizing currencies, such a tax could destabilize the markets through a lack of liquidity. The solution, then, does not lie in controls on movements of capital.

Financial market forces can be very useful in constraining governments from acting without a sound basis and do not hesitate to punish governments acting without such a basis. They force governments to make choices. Policies that ensure stability do attract capital inflows. Governments can choose other paths, but they must then live with the consequences.

If the markets are convinced that inflation is fully under control, access to capital will be facilitated. Canada offers a good example of this situation. Because market forces are now convinced that the policy adopted by the Bank of Canada is credible and will prevent any recurrence of inflation, Canada's obligatory markets have been able to resist recent upheavals. Despite changes in the American market, the Canadian dollar has rarely been as stable as it is at the present time. Some people anticipate that there will be major interest rate hikes in the United States. Canada will be able to resist this upward pressure. Because the markets are increasingly convinced that Canada has succeeded in checking inflation and that the current account balance and the state of government finance is constantly improving, it is unlikely that the rate increases in the United States will put upward pressure on Canadian rates. At the very most, rates will stabilize. The markets will not be as demanding with respect to Canada as they will to our neighbours to the south.

The markets also like to be reassured periodically. Governments must display openness in their tax and monetary policies (as Canada did in adopting a target range for

(17) Standing Committee on Finance, *Record of Proceedings and Testimony*, 5 May 1995, p. 134:20-21.

inflation and a deficit:GDP ratio) and publish their accounts on a regular basis (as the Bank of Canada does by publishing a semi-annual Report on Monetary Policy and the government of Canada does by publishing an economic and financial update). The markets can in this way determine whether or not governments are achieving their objectives. What is even more important is the fact that, because the authorities publish the relevant information, market forces will always react promptly; thus, the remedy they impose will be easier to swallow.

In a situation where government finance is administered soundly and inflation is held in check, governments can govern freely, as they always have done. If a government has the resources to build bridges and create health systems and universities, the markets will not react against such efforts.

If a government spends too much and has lost control of its finances or is handling inflation badly, market forces will make themselves heard. Government always has the option of applying whatever policy it chooses, but it cannot prevent market forces from reacting to those policies.

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19